

R&D Tax Reliefs: consultation on a single scheme

Consultation response from the Royal Academy of Engineering

6 March 2023

1. The Royal Academy of Engineering welcomes the opportunity to respond to HM Treasury's R&D Tax Reliefs Review: Consultation on a single scheme. The Academy's submission has been informed by the expertise of its Fellowship, which represents some of the nation's best practicing engineers and engineering entrepreneurs and business leaders, and its Enterprise Hub. The [Enterprise Hub](#) supports the most promising engineering and technology entrepreneurs. Established in 2013, it has supported over 300 researchers, recent graduates, and SME leaders to start up and scale up their businesses. Hub Members have gone on to raise over £1 billion in additional funding and create over 5100 new jobs. From manufacturing to medtech, the Hub members are some of the UK's most innovative entrepreneurs. Our response to this consultation focuses on the perspectives of Hub members and their experiences working in deep tech firms and other innovation-focused SMEs.

2. Tax incentives, including R&D tax reliefs, have long been recognised by engineering businesses as important measures to support business R&D investment in the UK^{1,2}. R&D tax reliefs can encourage large multinational companies to invest in R&D in the UK, as they decrease the relative cost of the work. While, for small companies, the tax reliefs can promote R&D investment by increasing cash flow to respond to opportunities as they arise. As we highlighted in our response to HM Treasury's consultation on R&D Tax Reliefs in 2021³, R&D tax reliefs enable small research-intensive high-tech innovative companies to do more R&D on their own terms. For small innovative companies, R&D tax reliefs play a crucial role in increasing their available finance. Unlike innovation grants allocated to specific projects, this allows them to respond to emerging business opportunities and threats as they arise, including through further R&D investment. Returns from R&D tax reliefs can be a lifeline in periods of challenging cash flow.

3. By their nature, R&D-focused companies are frequently capital-intensive with long timelines for their work. These companies are exposed to a great deal of risk and can spend long periods of time loss-making before the innovative technologies they work on can reach market-readiness. Tax relief, as well as other sources of income such as grants, provide room for these companies to navigate the startup and scale-up phases of their businesses. The support given as part of the current SME scheme is central to how these entrepreneurs plan for the future and frequent and substantial changes to

¹ [Increasing investment in R&D: business perspectives](#), RAEng, 2018.

² [Late-stage R&D: business perspectives](#), RAEng, 2021

³ [R&D Tax Reliefs: consultation](#), RAEng, 2021

government policy in this area reduces their ability raise outside funding and respond to market changes. The current system also allows for companies whose initial focus requires intensive R&D to endure losses while they develop and productise their innovative ambitions.

4. The generosity and generality of the current SME scheme is vital to the UK's ambitions to support the continued growth of R&D companies, and changes that reduce the rate of support for these innovative companies risk holding back the UK's economic growth. Hub members strongly disagreed with the proposition that the current SME scheme be removed and expressed concerns that any subsequent single scheme would not adequately support R&D-intensive firms in the UK.

5. Hub members also took time in their submissions to object to changes to the existing SME scheme announced in November 2022, particularly the lowering of the additional deduction from 130% to 86% and the reduction of the SME credit rate from 14.5% to 10%. Under these and future reforms, many respondents had concerns that their businesses would suffer and that this would affect their decision to carry out R&D in the UK. With the government's ambition to be a science and innovation superpower, ensuring the UK's business environment remains attractive for R&D intensive businesses of all sizes is crucial. Tax incentives are a significant part of that landscape. Therefore, any changes to the UK's R&D tax relief for SMEs need to be weighed against these considerable stakes.

Responses to questions

Q1) Do you agree a new scheme should be an above the line RDEC like credit? If not, what alternative would you propose?

6. An above the line scheme such as the RDEC does not provide adequate support for companies in the startup stage or otherwise early in their market journey. Many deep tech, R&D-intensive firms spend a great deal of their early years loss-making so the greater support gained through the SME scheme provides a vital source of income these firms.

7. However, while Hub members were almost unanimous in disagreeing with the proposal for any future single scheme to be based on an above the line credit, they were more concerned for the overall generosity of the scheme. According to Hub members, for a scheme based on the RDEC to work for high-tech SMEs, the credit rate would need to be increased, with one Hub member suggesting the rate would need to be closer to 33.35% for equivalent benefit. In the words of another Hub member: "The rate should be higher for loss-making companies as companies who engage in R&D regardless of their loss-making status are the ones that should be rewarded the most and who need the largest support to make their R&D commercially-ready".

Q2) Does the taxability and subsequent different post tax net benefits impact your decision making when allocating R&D budgets? Does claiming for expenditure on qualifying indirect activities influence your decision to undertake R&D?

8. Hub members were divided between those who said that R&D tax relief incentivised them to carry out more R&D and those whose company's sole purpose was research, to whom the relief was essential. As mentioned, these companies are typically deep tech, innovative firms, working in areas vital for future UK economic success, such as novel materials, medical technology, and future battery technology.

9. For loss-making enterprises, the direct taxability benefits were not always available to them, but Hub members said that making the R&D tax credit non-taxable would be a net benefit for any SME and provide them with a larger budget to conduct additional R&D.

10. Regarding claiming against indirect activities, respondents saw the restrictions in the current scheme as too strict. Were the ability to claim on indirect activities removed completely, one respondent said that they would consider reducing their workforce in the UK and moving to rely more on contracted work in other countries.

Q3) Do you agree the same treatment of subcontracting should apply to all claimants in the merged scheme? If so, where R&D activity is subcontracted, do you think that the customer should claim the tax relief, as in the SME scheme, or the subcontractor, the person carrying on the R&D, as in the RDEC? Can you see any positive or negative impacts on your business or sector from the Government adopting either approach?

11. Hub members saw it as “absolutely necessary” that SMEs continue to be able to claim for work they employ sub-contractors to complete. As SMEs took on all the risk of engaging in R&D, while the subcontractor engaged in work for an agreed fee, regardless of the ultimate success of the research, it makes sense for the SME and not the subcontractor to claim for tax relief.

Q4) Which of the SME and RDEC PAYE & NICs cap should the Government implement in the new scheme? Should the Government change the way either cap is calculated if it is taken forwards? And if so, how?

12. Hub members see the value to protecting against fraud. While they have found the current caps workable, they also saw opportunities for improvements. A frequent example given by Hub members concerned situations where a small company undertakes R&D with expensive equipment or engages a subcontractor for an expensive task, in which the relatively small size of their payroll may leave them penalised.

13. One Hub member gave as an example the UK medical technology sector as replete with small, innovative firms, reliant on subcontractors to carry out clinical trials. The cost of a trial can be significantly more than 15% of a company’s qualifying expenditure, and often, loss-making R&D-heavy SMEs must operate efficiently with a relatively small team that is almost exclusively focused on R&D since no commercial activities can occur until regulatory approval is obtained.

14. Hub members suggested that introducing banding into how relief is capped could be a solution. They recognised, however, that this would introduce further detail into an already complex system. In any case, respondents agreed something close to the SME cap should be retained, but that the future system needed to recognise and support companies that operate in different ways.

Q5) Do you consider the government should provide more generous support for different types of R&D or more R&D intensive companies relative to less R&D intensive companies?

15. More generous support for UK SMEs engaged in deep tech and other R&D-intensive activities is vital if the UK is to achieve its ambition of being a Science Superpower. Hub members emphatically agreed that the government should give more generous

support to businesses performing R&D. The UK lacks no wealth of innovative ideas but so often fails to bring these ideas to full fruition within the market. However, we regularly witness extremely promising companies who wish to grow in the UK facing tough decisions to exit earlier than would otherwise be desirable for the company or 'UK plc' or moving offshore to achieve scale.

16. As the Academy explored in our *Late-stage R&D* report⁴, businesses must consider a broad range of factors including market trends, intellectual property rights, trade and export policies, and opportunities posed by government strategies and roadmaps and the tax environment when making decisions to trade and grow in the UK. The Academy has called previously for the UK to move to unlock greater growth capital for innovative companies, but the support given early in a firm's life by the SME tax relief scheme is a vital component to support companies' transitions from idea to wider investment and onto market success.

Q6) How can Government ensure SMEs are supported in the transfer into a new scheme?

17. Companies cannot react to changes in government policy instantly. For R&D-intensive companies, rates of R&D tax relief hold a key place in business planning. Whether and when a company approaches venture capital, whether it decides to hire more staff, whether it decides ultimately to cease business activities – all of these decisions are made with levels of R&D tax relief in mind.

18. Hub members were unanimous in calling for the government to give more notice for firms to manage any transition. For companies that rely heavily on the support given through R&D tax relief, the period between November and April that was given for changes to the existing SME scheme left many SMEs with a "significant funding shortfall which they [had] no time to prepare for".

19. Furthermore, another respondent added that the announcement of this consultation has only added to confusion among R&D-intensive SMEs. What is needed, in their view, are "opportunities for industry input and setting expectations clearly in good time, timely communication, absolute clarity, and accessible mechanisms for ongoing support and discussion".

20. To quote one member "taking something away with no working and no substitute makes it very difficult for business".

Additional comments

21. In their submissions, Hub members expressed concerns regarding the way that grants are treated under the current SME scheme. For R&D-intensive companies, grants represent an important source of income, especially in the startup and scale-up phases. As grants are ineligible under the SME scheme, companies are forced to engage with the RDEC scheme. Some respondents suggested integrating grant income into the SME scheme for R&D-intensive companies.

⁴ [Late-stage R&D: business perspectives](#), RAEng, 2021

